

## Message Text

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ACTION EUR-08

INFO OCT-01 SS-14 ISO-00 EB-04 NSC-05 INR-05 CIAE-00  
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FM AMEMBASSY LISBON  
TO SECSTATE WASHDC PRIORITY 2932

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 6915

LIMDIS

E.O. 11652: GDS  
TAGS: EFIN, PO  
SUBJ: PORTUGUESE FINANCIAL SITUATION

REF: (A) LISBON 6628, (B) LISBON 5271

SUMMARY: FINANCE MINISTER MEDINA CARREIRA TOLD ME HE AND THE CENTRAL BANK WERE OVERRULED BY SOARES ON PACKAGE II. SOARES HAD ACCEPTED SOUSA GOMES'S OPTIMISTIC VIEW THAT DEVELOPMENT WOULD RESOLVE THE COUNTRY'S FOREIGN EXCHANGE PROBLEMS. SOUSA GOMES HAD BEEN SUPPORTED BY SALGADA ZENHA, FIRMINO MIGUEL AND NOBRE DA COSTA, THE LATTER HAD MAINTAINED THAT DEVALUATION WOULD NOT INCREASE EXPORTS. MEDINA CARREIRA, WHO HAD ARGUED FOR 8-10 PERCENT DEVALUATION, TOLD SOARES HE COULD NO LONGER CONTINUE IN A GOVERNMENT WHOSE POLICIES HE COULD NOT SUPPORT. MEDINA CARREIRA THOUGH THERE WAS STILL TIME TO TURN THE SITUATION AROUND BUT THAT SOUSA GOMES AND SOARES HAD TO BECOME DIRECTLY ACQUAINTED WITH THE FACTS OF LIFE. IN THE MEANTIME THE BANK OF PORTUGAL WOULD LET THE ESCUDO FALL AS RAPIDLY AS POSSIBLE. I TOLD MEDINA CARREIRA I INTENDED TO REGISTER MY PERSONAL CONCERN OVER THE WEAKNESS OF THE MEASURE TO SOARES NEXT WEEK. HE SAID THIS WOULD BE HELPFUL. HE WAS ALSO URGING SOARES TO NAME SOUSA GOMES TO NEGOTIATE  
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WITH THE IMF HERE AND IN WASHINGTON TO PUT HIM IN TOUCH WITH REALITY. END SUMMARY.

1. I LUNCHEDE SEPT 6 ALONG WITH FINANCE MINISTER MEDINA CARREIRA. AT THE OUTSET I EXPRESSED MY EXTREME DISAPPOINTMENT AT THE LESS THAN ADEQUATE MEASURES TAKEN BY GOP TO DEAL WITH FOREIGN EXCHANGE CRISIS (REFTEL A). I TOLD HIM THAT

SOME OF THE STEPS WERE IN THE RIGHT DIRECTION, BUT IT APPEARED TO ME THAT THE GOP HAD MISSED THE GOALPOSTS. THEY HAD DONE JUST ENOUGH TO AROUSE PUBLIC IRE BUT HAD FAILED TO DEAL WITH THE MOST FUNDAMENTAL PROBLEMS. THE COMBINED INTEREST RATE/FOREIGN EXCHANGE FLOAT FELL SHORT OF BEING ABLE EITHER TO REATTRACT THE CAPITAL THAT HAD FLED THE COUNTRY OR TO PROMOTE SUBSTANTIAL INVESTMENTS. SURE, PORTUGAL COULD SQUEAK BY, BUT I WAS VERY MUCH AFRAID THAT TWO OR THREE YEARS FROM NOW THE GOVERNMENT WOULD BE ANNOUNCING PACKAGE 13 OR 14 TO DEAL WITH A STILL HIGH INFLATION AND UNEMPLOYMENT RATE. EQUALLY IMPORTANT, THE GOVERNMENT HAD APPARENTLY UNDERESTIMATED THE DIFFICULTIES OF THE FORTHCOMING NEGOTIATIONS WITH THE IMF. THIS WAS A MISTAKE SINCE MEASURES TAKEN SUBSEQUENT TO NEGOTIATIONS WITH THE IMF WOULD PROVIDE GRIST FOR THE COMMUNIST PROPAGANDA MILL. THUS THE GOVERNMENT HAD MISSED AN OPPORTUNITY TO TAKE ON ITS OWN INITIATIVE MEASURES IN SUFFICIENT DEPTH TO RESOLVE THE COUNTRY'S PROBLEMS OVER THE LONG TERM AND AT THE SAME TIME AVOID ACCUSATIONS THAT IT CAPITULATED TO PRESSURE FROM THE IMF. THIS WAS DOUBLY UNFORTUNATE SINCE IN MY JUDGMENT THE COUNTRY HAD BEEN PSYCHOLOGICALLY PREPARED FOR DEVALUATION.

2. MEDINA CARREIRA SAID HE AGREED THOROUGHLY WITH EVERYTHING I HAD SAID. HE PERSONALLY HAD REACHED THE END OF THE LINE. HE HAD CONSISTENTLY ARGUED FOR TOUGH MEASURES BUT HE WAS TIRED OF BEING ON THE LOSING SIDE. HE HAD PROPOSED A STRONG  
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PROGRAM RIGHT AFTER THE GOVERNMENT TOOK OFFICE BUT THE GOP HAD PROCRASTINATED. PACKAGE I WAS TOO LATE AND TOO LITTLE, AND PACKAGE II WAS UNREALISTIC. THE MINISTER OF FINANCE HAD CONSISTENTLY BEEN SECOND GUESSED BY MINISTERS WHO WERE LESS INVOLVED IN FINANCIAL PROBLEMS BUT WHO COULD APPEAL MORE TO SOARES' INNATE OPTIMISM. AS FAR AS THE CURRENT MEASURES WERE CONCERNED HE HAD ARGUED FOR A TEN PERCENT DEVALUATION (WITH A FALLBACK POSITION OF EIGHT PERCENT) TO BE FOLLOWED BY A CRAWLING PEG. COUPLED WITH A SUBSTANTIAL INCREASE IN INTEREST RATES HE THOUGHT THIS WOULD BE SUFFICIENT TO REATTRACT SPECULATION CAPITAL. OTHERS HAD ARGUED THAT THIS WOULD IMPEDE THE DEVELOPMENT PROCESS, THAT INVESTMENT WAS COMING IN ANYWAY AND THAT SPECULATORS SHOULD NOT BE REWARDED. HE DISAGREED WITH ALL THESE ARGUMENTS, AND CONSIDERED THE LAST ONE PETTY.

3. MOST INFLUENTIAL AMONG THE "OPTIMISTS" WAS PLANNING MINISTER SOUSA GOMES WHO WAS COMPLETELY OUT OF TOUCH WITH REALITY BUT WHO HAD THE PRIME MINISTER'S TOTAL CONFIDENCE. THE PRIME MINISTER WAS UNABLE TO MAKE THE DISTINCTION BETWEEN DEVELOPMENT AND BALANCE OF PAYMENTS PROBLEMS. AS LONG AS HE RECEIVED GOOD NEWS FROM SOUSA GOMES ON THE DEVELOPMENT FRONT

HE THOUGHT THE BALANCE OF PAYMENTS PROBLEM WOULD INEVITABLY RESOLVE ITSELF. SOUSA GOMES HAD BEEN SUPPORTED IN HIS VIEWS BY SALGADA ZENHA, WHO THOUGHT IT WOULD BE EASY TO CONTINUE TO ARRANGE FOREIGN SUPPORT, AND BY MINISTER OF INDUSTRY NOBRE DA COSTA WHO ARGUED THAT DEVALUATION WOULD NOT INCREASE EXPORTS. THE LATTER MISSED THE POINT, BUT HAD CARRIED WEIGHT.

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ACTION EUR-08

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FM AMEMBASSY LISBON

TO SECSTATE WASHDC PRIORITY 2933

C O N F I D E N T I A L SECTION 2 OF 2 LISBON 6915

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4. MEDINA CARREIRA SAID THE PACKAGE II DECISION WAS GOING HIS WAY UNTIL ABOUT FOUR DAYS BEFORE THE ANNOUNCEMENT. AT THAT POINT SOARES SWUNG AROUND TO SOUSA GOMES' VIEWPOINT. MEDINA CARREIRA TOLD SOARES THAT HE COULD NO LONGER CONTINUE IN A GOVERNMENT THAT WAS SO BADLY DIVIDED ON FUNDAMENTAL POLICY. IF SOARES WISHED TO CONTINUE TO BASE HIS POLICIES ON WHAT HE, MEDINA CARREIRA, CONSIDERED TO BE FALSE OPTIMISM HE SHOULD PUT ONE OF THE OPTIMISTS IN THE FINANCE MINISTER'S POST. HE WOULD LIKE TO LEAVE AT THE EARLIEST POSSIBLE MOMENT. SOARES HAD TRIED TO TALK HIM INTO STAYING BUT MEDINA CARREIRA HAD MADE UP HIS MIND TO LEAVE NO LATER THAN OCTOBER.

5. MEDINA CARREIRA SAID THAT HE HAD STRONGLY RECOMMENDED TO SOARES THAT HE PLACE SOUSA GOMES AT THE HEAD OF THE TEAM TO NEGOTIATE WITH THE IMF. THE IMF TEAM WAS ARRIVING ON THE 19TH, AND THE PORTUGUESE TEAM WOULD THEN GO TO WASHINGTON ON THE 26TH. HE THOUGHT IT IMPORTANT THAT SOUSA GOMES, WHO HAS SOARES' UNQUALIFIED CONFIDENCE, BE EXPOSED TO REALITY. HE HOPED THAT USG AND IMF OFFICIALS WOULD BE AS BLUNT AS POSSIBLE WITH HIM.

6. I INDICATED THAT I INTENDED TO HAVE A CONVERSATION WITH SOARES IN WHICH I MADE THE POINTS I HAD MADE EARLIER TO THE

MINISTER, AND I RECALLED OUR CONVERSATION AT SOARES'  
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SUMMER HOME ON JULY 9 (REFTEL B). MEDINA CARREIRA SAID I HAD BEEN FAR BLUNTER THAN HE HAD EXPECTED ME TO BE. THE MESSAGE WE WERE GIVING WAS CLEAR BUT THE PORTUGUESE FAITH IN A SAVIOR THAT WOULD PULL THEM THROUGH ("SEBASTIANISMO") SEEMED TO HAVE INFLUENCED THE GOVERNMENT.

7. MEDINA CARREIRA SAID THAT UNDER PRESENT CONDITIONS SOARES WOULD HAVE A VERY DIFFICULT TIME FINDING A CAPABLE FINANCE MINISTER. ALL THE OBVIOUS CANDIDATES (VASCO VIERA DE ALMEIDA, SANTOS SILVA, JOAO SALGUEIRA AND SILVA LOPES) WOULD REFUSE THE JOB. IN FACT, MEDINA CARREIRA WAS RIGHT NOW TRYING TO PERSUADE SILVA LOPES NOT TO RESIGN, AND ASKED IF I WOULD HELP. THE MOST LIKELY POSSIBILITY WAS TO MOVE SOUSA GOMES TO FINANCE TO ROUND OUT THE "TEAM OF OPTIMISTS." IN THAT CASE HE THOUGHT THE COUNTRY COULD ROCK ALONG FOR ANOTHER FOUR TO SIX MONTHS UNTIL IT REALIZED THAT IT COULD ONLY SPEND \$60 MILLION A MONTH INSTEAD OF \$100 MILLION A MONTH. AT THAT TIME THERE WOULD BE A DRASTIC DROP IN CONSUMPTION WITH ALL THE RAMIFICATIONS THAT ENTAILED. CZDLTPA CARREIRA WORRIED THAT THE PRESENT POLICIES WERE PAVING THE WAY FOR A STRONG FINANCE MINISTER REMINISCENT OF ANOTHER ERA.

8. MEDINA CARREIRA FELT THERE WAS TILL TIME TO SAVE THE SITUATION IF SOARES AND THOSE IN WHOM HE HAD CONFIDENCE COULD BE BROUGHT TO UNDERSTAND REALITY. THE CENTRAL BANK HAD NOT BEEN PUT UNDER ANY CONSTRAINTS ON THE FLOAT AND WOULD LET THE ESCUDO DROP AS RAPIDLY AS POSSIBLE. IT WOULD ALSO ANNOUNCE PLANS FOR THE DROP OVER AN EXTENDED PERIOD, POSSIBLY SIX MONTHS. THIS WOULD HELP. IT WOULD ALSO HELP IF THE USG PULLED NO PUNCHES IN DEALING WITH SOUSA GOMES IF HE HEADS THE DELEGATION TO WASHINGTON.

9. I SAID THERE WAS LITTLE DOUBT THAT THE USG WOULD URGE  
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MORE REALISTIC POLICIES ON THE GOP. WE HAD MADE A SUBSTANTIAL EFFORT TO PROVIDE INTERNATIONAL SUPPORT FOR PORTUGAL ON THE GROUNDS THAT THE GOP WOULD DO WHAT IS NECESSARY. RECENT MEASURES HAD CALLED INTO QUESTION THE GOP'S ABILITY TO READ THE ECONOMIC SIGNS AND TO ACT ACCORDINGLY, AND I INTENDED TO CONVEY THIS MESSAGE PERSONALLY TO THE PRIME MINISTER WHEN HE RETURNS FROM VACATION NEXT WEEK. MEDINA CARREIRA URGED ME TO DO THIS NOT ONLY WITH THE PRIME MINISTER, BUT ALSO

WITH SOUSA GOMES, FIRMINO MIGUEL AND SALGADO ZENHA.

10. COMMENT: I MADE CLEAR THE ABOVE REFLECTED MY PERSONAL VIEWS, BUT I THOUGHT WASHINGTON WOULD NOT DISAGREE. I HAVE ASKED FOR A MEETING WITH PRIME MINISTER SOARES NEXT WEEK. IF WASHINGTON FEELS THAT I SHOULD BE COMMUNICATING A MESSAGE DIFFERENT FROM THE ONE DESCRIBED ABOVE WOULD APPRECIATE GUIDANCE.  
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